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Article

Chinese central bank's innovative monetary policy

The new Chinese central bank governor's first monetary policy move is innovative and the impact is clear

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The People's Bank of China (PBoC) has cut reserve ratio requirement (RRR) by one percentage point for banks that had a required ratio of 17% or 15%. If banks had a lower ratio, they will not enjoy the RRR cut.

The cash then released by the one percentage RRR needs to be used to repay existing medium-term lending facility (MLF) that banks have borrowed from the central bank at a high interest-rates. This would lower interest costs for the banks, but the extra liquidity will not go into the loan market.

This could be a pre-emptive move because if there was a trade war between China and the US, Chinese SMEs are the ones most likely to get hurt

If the banks don't have much to repay then the extra cash from the RRR cut needs to be used to lend to small and medium-sized enterprises (SMEs), and these lending activities would be included in the coming macro-prudential assessment (MPA) by the central bank.

The impact is lower interest costs for Chinese SMEs

By doing so, there would be CNY400billion net released of cash after banks repay their MLF.

And this CNY400billion is likely to be used on SMEs unless banks wish to contradict the central bank at their macro-prudential assessment, which we believe is unlikely.

PBoC's intention is also clear

Given that we know the impact of this innovative monetary policy, the intention of the central banks seems to be clear.

In the middle of a financial deleveraging reform, PBoC needs to raise interest costs for some financial activities, especially shadow banking but at the same time it does not want small firms to suffer from higher interest costs and this policy should serve this purpose well.

This could be a pre-emptive move because if there was a trade war between China and the US, Chinese SMEs are the ones most likely to get hurt.

Financial deleveraging yielding some results

The banks that benefit from this RRR cut are in general likely to face lower interest costs, and we think the central bank is now confident that the financial deleveraging reform is yielding some positive results.

But it does not mean that the central bank would relax tightening liquidity via daily open market operations. We believe that this "soothing" measure means financial deleveraging will continue and short-end interest rate would continue to rise after this RRR cut.

As exchange and interest rate policy has little linkage in China, we don't think this RRR cut would change the yuan's appreciation path.

We maintain our forecast of USD/CNY at 6.10 by the end of the year.

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